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Contents

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Y2K MARKETABILITY DISCOUNTS AS REFLECTED IN IPOs

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Recently, Valuation Advisors LLC completed its second study of the discounts for lack of marketability of Initial Public Offerings (IPOs) in 2000. We used the same parameters as we used in our 1999 study,[1] published in the Spring 2000 issue of *CPA Expert.* Our study separates marketability discounts into periods of three-month intervals for the 12 months immediately before the IPO, and into a single period for the timeframe from one to two years before the IPO. A sample of the study results is shown on page 5.

We added a few new features to the 2000 study. First, we tracked the discounts on transactions of convertible preferred stock (CPS). We used the same three-month measuring periods as those used for common stock and options. Not surprisingly, the CPS discounts were similar to those of common stock. Second, we tracked those transactions that fall outside our "range" of discounts for inclusion in the study (our so-called *narrowed discount range*). Our narrowed discount range is for those discounts from 10% to 90% of the IPO price during the two-year period prior to the IPO. We excluded transactions outside this range because they may be either "cheap stock or options" or may be at a premium because of changing market conditions. (This aspect of the study is discussed in greater detail later in this article.)

Table 1 on page 2 shows the overall results of our 2000 study (both common and preferred stock, and all discounts and premiums). The overall discount for the entire one-year period averaged 47.07%. When we simply included the transactions in the middle-range (see table 2), the average one-year discount increased to 52.40%. When we excluded the CPS transactions, the narrowed discount range for common stock or options only fell to 49.76%, down from the 1999 figure of 52.44% (see table 3). The decline would likely indicate that for 2000 IPOs there were more premiums paid than large discounts on pre-IPO transactions.

Table 4 shows the results for the CPS-only discounts. With the exception of the first three months, every other CPS period, compared with the common-stock-only transactions, shows a reasonably larger discount. This may be explained partially by the fact that these transactions typically are at larger dollar amounts than the majority of the common stock and option transactions, thereby allowing venture capital firms engaging in such transactions to negotiate better deal terms. Also, to the extent that common-stock-based transactions use CPS transactions as a benchmark, the common transactions are usually priced higher thereafter, even though they may fall in the same three-month period.

Table 5 shows the number of premium transactions by quarter. A review of these transactions showed

1 "1999 Marketability Discounts as Reflected in Initial Public Offerings," Brian K. Pearson, *CPA Expert,* Spring 2000.

Table 1: Complete Study Results

TIME OF TRANSACTION BEFORE IPO	1–90 DAYS	91–180 DAYS	181–270 DAYS	271–365 DAYS	1–2 YEARS
Number of transactions	123	165	105	86	134
Average discount	31.50%	43.58%	56.47%	64.39%	71.61%
Average one-year discount	47.07%				

Table 2: Narrowed Discount Range

TIME OF TRANSACTION BEFORE IPO	1–90 DAYS	91–180 DAYS	181–270 DAYS	271–365 DAYS	1–2 YEARS
Number of transactions	99	146	94	73	106
Average discount	40.60%	49.29%	59.16%	65.95%	66.85%
Average one-year discount	52.40%				

that the majority occurred during the third quarter. What causes premiums to occur? For those companies that were not "hot" offerings (those whose shares are oversubscribed in the offering), the only way to complete an IPO as the year progressed was to lower the IPO price,[2] sometimes more than once.[3] As the IPO price was lowered to generate additional buyers necessary to complete the offering, the price often ended up being lower than prior prices for options and common and preferred stock already issued or sold. This was primarily because capital markets were more difficult for an IPO.

Generally, as the stock markets fell as the year progressed, investors were more selective in investing in IPOs.[4] Thus, many companies lowered their offering prices to complete an offering in the third quarter while the IPO window was still open. By November, half the 2000 IPOs were trading below their IPO price.[5] Essentially, as investors became more selective, they were less willing to pay higher valuation multiples for all companies.

OVERSTATED MARKETABILITY DISCOUNTS?

This condition—paying higher valuation multiples—raises an interesting issue. Some valuation professionals argue that IPO studies calculating marketability discounts overstate discounts since IPOs overstate the true fair market value of a company's shares. In general, however, this is simply not true. First, in both 2000 and early 2001, several companies lowered their offering prices to go public. Over time, this tends to offset raised offering prices in better markets. Second, in 2000, several companies cancelled their offerings because the IPO market simply dried up. Table 6, which is reproduced from IPOMonitor.com, shows the number of IPOs and the number of withdrawn offerings by quarter in 2000. There were 422 IPOs in 2000 and 232 withdrawn offerings. Thus 35% of all companies filing offerings

2 "Firms Lower Prices, Withdraw Offerings As IPO Market Slows," Raymond Hennessey, *Wall Street Journal,* Thursday November 16, 2000, p. C20.
3 "New Year Won't Ring in Bells in IPO Market," Raymond Hennessey, *Wall Street Journal,* Tuesday January 2, 2001, p. C15.
4 "IPO Window Shuts As Crop of Newly Public Firms Withers," Jed Graham, *Investors Business Daily,* Friday December 22, 2000, p. A6.
5 "With fewer filers, lower prices, IPO market 'pretty ugly out there,'" Matt Krantz, *USA Today,* Monday November 13, 2000, p. 16B.

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Table 3: Narrowed Discount Range—Excluding CPS Transactions

TIME OF TRANSACTION BEFORE IPO	1–90 DAYS	91–180 DAYS	181–270 DAYS	271–365 DAYS	1–2 YEARS
Number of transactions	82	95	53	49	50
Average discount	39.56%	47.64%	56.98%	63.17%	63.54%
Average one-year discount	49.76%				

Table 4: CPS Transactions Only

TIME OF TRANSACTION BEFORE IPO	1–90 DAYS	91–180 DAYS	181–270 DAYS	271–365 DAYS	1–2 YEARS
Number of transactions	24	56	43	30	73
Average discount	31.83%	47.78%	57.51%	73.00%	75.45%
Average one-year discount	52.96%				

never made it public. No prior lack of marketability studies (including ours) captures the presumed increase in lack of marketability in those companies whose offerings were cancelled or withdrawn.

Third, once an IPO is cancelled, other potential investors may view the company differently because they know one avenue for liquidity is closed, maybe permanently. According to a study by finance professor Craig Dunbar, only 10% of failed IPOs ever manage to go public at a later date.[6] Fourth, to the extent a failed IPO means the company does not have funding to complete its business strategies, its attractiveness to investors as a competitor in its industry is lessened. Dunbar says, "Withdrawing an IPO is usually a crippling event, even if the company doesn't realize it at the time." Ironically, these drawbacks must be weighed against the likelihood that the company may now seek a buyer for itself as a strategy to continue growth, thereby creating liquidity for investors.

Based on the large number of companies that file and don't go public, and those that simply will never be able to go public, one can argue the discount for a private company could be higher than the averages in this study. For example, in poor markets, any IPO takes longer. According to alert-IPO.com,[7] "Companies that priced IPOs in March this year had spent an average of about 73 days in registration, but in October the average number of days surged to 161."

Table 5: Premiums by Quarter

QUARTER	PREMIUMS	TRANSACTIONS	% OF TOTAL
1st	2	217	0.92%
2nd	4	64	6.25%
3rd	21	216	9.72%
4th	5	116	4.31%
TOTAL	32	613	5.22%

If we assume the average IPO process (from filing to successful offering) takes approximately six months, a way to calculate this additional lack of marketability is to look at the difference between six-month intervals of our study. The discount difference between the 181–270 day period and the 1–2 year period was approximately 15.14% in 2000 and 11.35% in 1999. Since in both years, the discount for the 181–270 day period is considerably greater than the average discount for all time periods, this may be a good base period to use in looking at the discount for an additional theoretical six-month period. Clearly, the companies in our study are more liquid to an investor than the average privately held company valued. Thus, for an "average" privately held business, this may be one approach to capturing the potential additional lack of marketability that we need to consider further.

NAICS CATEGORIES

As we did last year, we classified all our transactions in the study by NAICS code. In table 7, we present the companies included in the NAICS categories 325, "Chemical Manufacturing," and 334, "Computer and Electronic Product Manufacturing." The discounts by NAICS category vary with the number of transactions in that category, as well as the timing of the transaction (first vs. fourth quarters). We presented

6 "Public Skeptical—A company's IPO withdrawal could either be fatal, or a windfall," Jon Birger, *Red Herring*, August 2000, pp. 354-356.
7 "IPO View—New stock offerings wait out rollercoaster," Denise Duclaux, Reuters Limited, via America Online.

Table 6: IPOs and Withdrawals in 2000

QUARTER	IPOs	WITHDRAWALS
1st	136	20
2nd	95	78
3rd	137	47
4th	54	87
TOTAL	422	232

Note: Reproduced from IPOMonitor.com

these two categories because both had at least five transactions for each time period.

IMPACT OF MARKET CONDITIONS

Another interesting fact that can be gleaned from the study is the nature of the "hot" market for IPOs in the first quarter. This can be seen in table 8, which separates the transactions by calendar quarter. In the three months just prior to the IPO, the first quarter discount was 41%, whereas the next two quarters were in the low 20% range, and the final quarter was 16.36%.

The first quarter of 2000 saw more than 250 IPOs, whereas the last quarter saw fewer than 100. Also, in the first quarter the average IPO price rose 98% on the first day of trading.[8] According to Hoover's Online, Web Methods went public February 11, 2000 at a price of $35. Its proposed IPO price range had been $28–$30. Thus, its IPO price was 15%–20% higher than its initial proposed price. Interestingly, its first day closing price was $212. A more modest example was Sequenom, which went public February 1, 2000 at $26, which was 10% higher than the proposed $23–$25 range. These examples clearly show why marketability discounts were exaggerated in the first quarter.

By the third and fourth quarters of 2000, the opposite was occurring. For example, according to Hoover's Online, Lantronix went public August 4, 2000 at $10, a price 25%–35% lower than its proposed range of $14–$16. Similarly, Aerogen went public on November 10, 2000 at $12, a somewhat more modest reduction from its proposed price of $13–$15. Clearly, these examples show why marketability discounts contracted in the third and fourth quarters of 2000.

These examples show how underwriters typically raised IPO prices in the first quarter, mostly maintained them in the second and third quarters, and often lowered them in the fourth quarter. On balance, this also points out the need to consider external market conditions. Clearly, the market conditions at a valuation date do have an impact on IPO valuations, and thus should be considered for private companies, even in the context of discounts.

Each valuation case should be viewed differently: There is no "one discount fits all" answer. Our studies this year and in prior years clearly indicate that over many industries and multiple time periods, investors have paid less for an investment the further away from the IPO liquidity event. Since this is intuitively what a logical investor would also do, our study results are a useful guide in gauging the lack of liquidity for closely held stock.

Table 7: Study Results—NAICS Codes 325 and 334

NAICS 325 TIME OF TRANSACTION BEFORE IPO	1–90 DAYS	91–180 DAYS	181–270 DAYS	271–365 DAYS	1–2 YEARS
Number of transactions	8	13	7	6	15
Average discount	32.17%	49.66%	56.66%	64.81%	70.88%
Average one-year discount	49.66%				

NAICS 334 TIME OF TRANSACTION BEFORE IPO	1–90 DAYS	91–180 DAYS	181–270 DAYS	271–365 DAYS	1–2 YEARS
Number of transactions	18	23	16	10	24
Average discount	30.46%	46.94%	58.79%	60.10%	69.07%
Average one-year discount	47.31%				

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Table 8: Study Results—1–90 Day Transactions by Quarter

QUARTER	NUMBER OF TRANSACTIONS	AVERAGE DISCOUNT
1st	57	41.00%
2nd	14	20.43%
3rd	28	21.97%
4th	16	16.63%

8 "IPO price rises in the aftermarket dropped noticeably," *Wall Street Journal*, April 3, 2000, p. C26.

Valuation Advisors, LLC

Sample from 2000 IPO Valuation Discount Study

COMPANY	NAICS CODE	PRINCIPAL BUSINESS DESCRIPTION	IPO PRICE	IPO DATE	TRANSACTION Price	TRANSACTION Date	TRANSACTION Type	% DISCOUNT FROM PUBLIC OFFERING PRICE — TRANSACTION DAYS BEFORE IPO: 1–90	91–180	181–270	271–356	366–730
Accelerated Networks, Inc.	3342	Communications equipment manufacture	15.00	6/23/00	3.39	3/15/99	CPS					77.40%
					11.14	3/15/00	CPS		25.73%			
					9.18	12/31/99	S		63.40%			
					11.70	4/28/00	O	22.00%				
ActivePower, Inc.	334419	Manufacture of electric power equipment	17.00	8/8/00	6.20	12/31/99	O			63.53%		
					5.25	11/15/99	CPS			69.12%		
Avici Systems, Inc.	3342	High-speed networking routers	31.00	7/28/00	8.35	9/15/99	CPS				73.06%	
					15.00	4/15/00	CPS		51.61%			
					8.00	3/31/99	CPS					74.19%
					12.50	3/31/00	S		59.68%			
Cypress Communications, Inc.	514	Communications services to businesses	17.00	2/10/00	4.01	4/7/99	O				76.41%	
					15.00	11/29/99	O	11.76%				
					4.22	10/8/99	CPS		75.18%			
					1.78	9/30/98	CPS					89.53%
Dyax Corp.	32541	Disease treatment and identification	15.00	8/15/00	5.45	10/15/98	CPS					63.67%
					5.21	7/14/99	S					65.27%
					13.00	6/15/00	O	13.33%				
eMachines, Inc.	44312	PC sales	9.00	3/24/00	6.38	8/15/99	O			29.11%		
Entegris, Inc.	54151	Microelectronic materials management solutions	11.00	7/11/00	6.25	8/31/99	S				43.18%	
					2.01	8/31/98	S					81.73%
Etinuum, Inc.	5416	E-business consultation	12.00	3/24/00	8.52	10/1/99	S		29.00%			
First World Communications, Inc.	514191	Network-based Internet service provider	17.00	3/8/00	7.50	2/10/00	S	55.88%				
					6.00	7/14/99	S			64.71%		
					4.02	3/2/99	S					76.35%
					3.68	1/7/99	S					78.35%
i3 Mobile, Inc.	513322	Personalized information to wireless users	16.00	4/6/00	3.11	2/12/99	CPS					80.56%
					7.92	12/22/99	CPS		50.50%			
					2.37	8/11/98	CPS					85.19%
					13.75	2/15/00	O	14.06%				
Illumina, Inc.	3391	Genetic testing equipment	16.00	7/28/00	9.00	3/15/00	S		43.75%			
					4.00	12/15/99	CPS			75.00%		
					0.93	11/15/98	CPS					94.21%
ISTA Pharmaceuticals, Inc.	32541	Discovery and drug development for eye diseases	10.50	8/22/00	5.63	3/15/00	CPS		46.38%			
					4.30	8/8/99	O					59.05%
					7.93	4/15/00	O		24.48%			
Large Scale Biology Corporation	325414	Proteomics and genomics development of products	17.00	8/10/00	12.50	12/30/99	O			26.47%		
Mainspring, Inc.	5416	Internet consulting services	12.00	7/27/00	9.19	3/31/00	O		23.42%			
					0.62	8/15/98	S					94.83%
					7.50	2/10/00	CPS		37.50%			
Mobility Electronics, Inc.	3341	Computer peripheral products	12.00	6/30/00	9.07	5/15/99	O					24.42%
					8.01	4/1/99	O					33.25%
					10.50	12/1/99	O			12.50%		
Neoforma.com, Inc.	541	Business to business medical products exchange	13.00	1/25/00	9.00	11/18/99	S	30.77%				
Nuance Communications, Inc.	54151	Voice interface software	17.00	4/13/00	12.00	12/31/99	O		29.41%			
					4.69	5/15/98	CPS					72.41%
					9.00	11/15/99	CPS		47.06%			
Onvia.com, Inc.	514191	E-business to business marketplace	21.00	3/1/00	11.00	12/15/99	O	47.62%				
Rosetta Inpharmatics, Inc.	621511	Informational genomics	14.00	8/3/00	11.00	3/16/00	S		21.43%			
					3.36	4/1/99	CPS					76.00%
Screaming Media, Inc.	54151	Internet digital content	12.00	8/3/00	5.81	7/17/00	CPS	51.58%				
					1.33	4/15/99	CPS					88.92%
					4.15	10/15/99	CPS				65.42%	
Sunrise Telecom, Inc.	514191	High speed Internet verification services	15.00	7/13/00	10.00	2/22/00	S		33.33%			
					5.00	12/31/99	S			66.67%		
					3.33	7/15/99	S				77.80%	
Telecommunication Systems, Inc.	3342	Wireless network application software and services	17.00	8/8/00	2.85	12/14/99	CPS			83.24%		
					15.00	4/15/00	O		11.76%			
					1.28	4/1/99	O					92.47%
WJ Communications, Inc.	3342	Broadband products for wireless and fiber communication	16.00	8/19/00	7.67	7/15/00	CPS	52.06%				
					9.87	3/15/00	O		38.31%			
					11.59	6/30/00	S	27.56%				
								1–90	91–180	181–270	271–356	366–730
						TOTAL AVERAGE DISCOUNT		32.66%	39.55%	54.48%	67.17%	74.09%

KEY:
CPS= convertible preferred stock
S = stock
O = option

BUILT-IN GAINS TAXES: BUSINESS VALUATION CONSIDERATIONS, PART I

Leonard J. Sliwoski, CPA/ABV, PhD, CBA, ASA and Mary B. Bader, CPA, JD, LLM

The approach used to value an operating company generally differs from the approach used to value a holding or investment company. The valuer of an operating company assumes a business will continue and generally measures value based on future earnings and resultant cash flow. In contrast, the valuer of a holding company generally assumes value is realized, not from future business earnings and resultant cash flow, but from the sale of business assets.[1] The Tax Reform Act of 1986 repealed the General Utilities doctrine, which held that a C corporation did not recognize gain when it distributed appreciated property to shareholders. After 1986, a built-in gains tax on appreciated corporate assets is unavoidable upon the sale or other disposition of such assets by the C corporation.[2]

The repeal of the General Utilities doctrine coupled with the myriad of business entity structures now available to business owners has created controversy among courts and valuers of operating and holding companies. This article focuses on that controversy—the question of whether built-in gains taxes of operating and holding companies should be taken into account in valuing C corporations, S corporations, and partnerships, including family limited partnerships, limited liability companies (LLCs), and limited liability partnerships (LLPs).

OPERATING COMPANIES

The value of operating companies arises from future earnings and resultant cash flow, not from the sale of business assets as of the appraisal date. Conceptually, built-in gains taxes of operating companies are similar to deferred income tax liabilities. Typically, deferred income tax liabilities are reclassified as equity, because payment may not occur, or payment may occur at a point so far in the future that the present value of such liabilities is minimal. As a result, regardless of whether operating companies are organized as C corporations, S corporations, or partnerships, including family limited partnerships, LLCs and LLPs, built-in gains taxes are generally not taken into account in valuing them.

When operating companies hold nonoperating assets in addition to operating assets, valuers generally assume nonoperating assets either will be purchased by buyers and sold immediately, or will be retained and sold by sellers. In other words, the value of nonoperating assets results from their ultimate sale. Accordingly, in such cases, a combination of an income approach and an asset approach may be used to value operating companies. (The following discussion, which relates to holding companies, is also applicable to nonoperating assets held by operating companies.)

HOLDING COMPANIES

To examine the issue of built-in gains taxes of holding companies, a simple example is useful. Assume two unrelated individuals, A and B, organized an entity on January 1, 1991. In exchange for a 50% ownership interest, A and B each contributed $10,000 cash. On that same date, the entity purchased a parcel of land for $20,000, which it holds for investment. The land is the only asset owned by the holding company. On January 1, 2001, the fair market value of the land is $100,000. On that date, the entity is valued.

Holding Companies Organized as C Corporations

If A and B organize the holding company as a C corporation, the value of the holding company relates to the land held for investment. In valuing the holding company, the valuer would most likely use an asset approach. In this example, if the corporation sold or otherwise disposed of the land, it would pay tax on the built-in gain of $80,000 ($100,000 fair market value of the land less the adjusted basis of the land to the corporation of $20,000). If the C corporation is in the 34% marginal bracket, the built-in gains tax on the land is $27,200 (34% of $80,000).

Courts have recognized the need to take built-in gains taxes into account when the valuation is done using an asset approach, because a hypothetical buyer would consider this income tax liability in computing the fair market value of holding company stock.[3] While courts recognize the need to take built-in gains taxes into account in valuing holding companies operated as C corporations, the approaches used by courts to do so have varied significantly.

In *Eisenberg* v. *Commissioner,* the Second Circuit Court of Appeals recognized the need to take built-in gains taxes into account in valuing the holding company, but remanded the case back to the Tax Court to determine the value of the holding

1 Rev. Rul. 59-60, 1959-1 C.B. 237 (1959).

2 The built-in gains tax discussed in this article is a broader concept than the §1374 built-in gains tax that applies to S corporations. In this article, the term "built-in gains tax" refers to the income taxes associated with appreciated property owned by a business entity.

3 See e.g. *Estate of Welch* v. *Commissioner,* No. 98-2007, 2000 WL 263309 (6th Cir. March 1, 2000); *Eisenberg* v. *Commissioner,* 155 F.3d 50 (2nd Cir. 1998), acq. in part, 1999-4 I.R.B. 4 (Jan. 25, 1999); *Estate of Borgatello* v. *Commissioner,* 80 T.C.M. (CCH) 260 (2000); *Estate of Simplot* v. *Commissioner,* 112 T.C. 130 (1999); *Estate of Jameson* v. *Commissioner,* 77 T.C.M. (CCH) 1383 (1999); *Estate of Davis* v. *Commissioner,* 110 T.C. 530 (1998); and *Estate of Dunn* v. *Commissioner,* 79 T.C.M. (CCH) 1337 (2000).

company. Thus, the *Eisenberg* court did not directly address the question of how to reduce corporate net asset value to reflect built-in gains taxes. The IRS acquiesced in part to *Eisenberg* by acknowledging possible recognition of built-in gains taxes in holding companies organized as C corporations, stating that "[w]e acquiesce in this opinion to the extent that it holds that there is no legal prohibition against such a discount. The applicability of such a discount, as well as its amount, will hereafter be treated as factual matters to be determined by competent expert testimony based upon the circumstances of each case and generally applicable valuation principles."

In *Estate of Simplot* v. *Commissioner*, the Tax Court allowed net asset value of a holding company to be reduced by the full amount of built-in gains taxes (combined state and federal rate of 40%). Applying the *Simplot* court's holding to the example above, would result in a valuation of the C corporation stock of $72,800 ($100,000 fair market value of land less $27,200 of built-in gains taxes).

In *Estate of Jameson* v. *Commissioner*, the Tax Court determined when the holding company would likely pay built-in gains taxes, calculated the net present value of the future built-in gains taxes, and reduced the net asset value of the holding company by this amount. The primary asset held by the holding company in *Jameson* was timberland. The holding company had an I.R.C. §631 election in effect, which meant it paid income taxes as timber was sold to buyers, who cut and harvested the timber. Based on the timberland management plan used by the holding company, the Tax Court determined that 10 years was the likely time period in which the holding company would pay built-in gain taxes on the sale of timber.

In *Estate of Dunn* v. *Commissioner*, the Tax court allowed a 5% reduction in net asset value to take into account the built-in gains taxes. This was an odd case in which the subject business was an operating company whose primary business was renting heavy equipment. In this case, the fair market value of the company determined by the "net asset value method" and the "capitalization of income method" were divergent. The Tax court recognized value of the company based on the weighted average net asset value method and the capitalization of income method. The 5% reduction for income taxes, which the Tax Court determined was appropriate because of the limited likelihood the corporation would be liquidated, was only applied to the net asset value valuation conclusion. Therefore, the reduction for built-in gains taxes was less than 5%, because the final value was based upon reconciliation of both valuation methods.

Table 1: Calculation of After-Tax Cash Received by C Corporation Stockholders

SALE OF STOCK	A	B	COMBINED
Sales price	$36,400	$36,400	$72,800
Adjusted basis of stock	(10,000)	(10,000)	(20,000)
Built-in gain	$26,400	$26,400	$52,800
Capital gain tax rate for individuals	x .20	x .20	x .20
Built-in gains taxes	$5,280	$5,280	$10,560
AFTER-TAX CASH RECEIVED	**A**	**B**	**COMBINED**
Sales price	$36,400	$36,400	$72,800
Less built-in gains taxes paid	(5,280)	(5,280)	(10,560)
After-tax cash received by A and B	$31,120	$31,120	$62,240

An Argument for Recognizing Built-in Gains Taxes in Operating Companies

An argument can be made for recognition of built-in gains taxes in operating companies in two circumstances. The first circumstance involves marginally profitable or unprofitable operating companies with significant equity in assets owned. These businesses are often appraised under an asset approach with a liquidation premise of value. If they organized as C corporations, built-in gains taxes should be recognized because the liquidation premise of value assumes assets will be sold, liabilities, including built-in gains taxes, will be paid and the corporation will cease doing business in the near future.

The second circumstance involves small operating companies organized as C corporations. Frequently, these entities are sold with the sale transaction structured as an asset sale, not as a stock sale. Business valuers generally appraise business equity not assets. If a sale of a small operating company is structured as a stock sale, some reduction in the purchase price typically occurs. This reduction occurs because lower depreciation and amortization income tax deductions are available to the buyer due to a lack of an income tax basis adjustment for assets purchased. For a discussion of the reduction in stock price for small operating companies organized as C corporations, *see* "Recent Cases and Valuation Model Show 'State of the Art' Built-In Gains Calculation" by John Cooper and Richard Gore, *Valuation Strategies*, January/February 2001, pp.4-13.

Table 2: Calculation of After-Tax Cash Received by Shareholders from C Corporation Liquidation*

CORPORATE-LEVEL TAX ON LIQUIDATION	C CORPORATION
Fair market value of land on date of distribution	$100,000
Adjusted basis of land	(20,000)
Built-in gain on distribution	$80,000
Marginal tax rate of corporation	x .34
Corporate level tax on distribution	$27,200

If the corporation's only asset is the land, A and B would each have to contribute $13,600 to the corporation, which would increase their stock basis from $10,000 to $23,600 apiece.

SHAREHOLDER-LEVEL TAX ON LIQUIDATION	A	B	COMBINED
Fair market value of distributed land	$50,000	$50,000	$100,000
Adjusted basis of stock	(23,600)	(23,600)	(47,200)
Built-in gain	$26,400	$26,400	$52,800
Capital gain tax rate for individuals	x .20	x .20	x .20
Built-in gains taxes at shareholder level	$5,280	$5,280	$10,560

SALE OF LAND BY A AND B	A	B	COMBINED
Sales price	$50,000	$50,000	$100,000
Adjusted basis of land	(50,000)	(50,000)	(100,000)
Recognized gain	$0	$0	$0

AFTER-TAX CASH RECEIVED BY A AND B	A	B	COMBINED
Sales proceeds from land	$50,000	$50,000	$100,000
Less cash contributed to corporation	(13,600)	(13,600)	(27,200)
Built-in gains taxes paid	(5,280)	(5,280)	(10,560)
After-tax cash received by A and B	$31,120	$31,120	$62,240

*Land was distributed to shareholders and they sold it to buyer.

Other courts have increased the lack of marketability discount by some percentage to take built-in gains taxes into account. For example, in *Estate of Davis* v. *Commissioner*, the Tax Court allowed a 15% increase in the lack of marketability discount to account for built-in gains taxes. The *Davis* court expressly rejected the notion that a lack of marketability discount equal to the full amount of built-in gains taxes should be applied in the absence of a planned liquidation of the holding company on the valuation date. Similarly, in *Estate of Borgatello* v. *Commissioner*, the Tax Court allowed a 24% increase in the lack of marketability discount to account for built-in gains taxes, but refused to increase the marketability discount to reflect the full amount of built-in gains taxes.

In *Estate of Welch* v. *Commissioner*, the United States Court of Appeals for the Sixth Circuit reversed the decision of the Tax Court, which denied the estate the right to discount the value of corporate stock to reflect a built-in gains tax liability on corporate real estate. The Sixth Circuit Court of Appeals, in remanding the case back to the Tax Court, stated that "[o]n remand, the petitioners, now aware of the required approach to valuation of the stock in light of *Eisenberg*, would need to present expert testimony to satisfy their burden of proof. They may or may not be able to present such testimony, but they should be given that opportunity."

TWO EMERGING SCHOOLS

These rulings reflect the two emerging schools of thought regarding built-in gains taxes of holding companies: (1) the full amount of the built-in gains taxes should reduce net asset value of the holding company; or (2) the lack of marketability discount should be increased by some percentage to take into account the built-in gains taxes. We believe, however, that the better approach is generally to reduce net asset values in holding companies organized as C corporations by the full amount of the built-in gains taxes.

Returning to the example above, assume a buyer wanted to purchase the land held by the C corporation. The buyer could potentially purchase the land from the C corporation or purchase stock held by A and B. If the C corporation sold the land to a buyer for its fair market value of $100,000, the C corporation would pay $27,200 of tax on the $80,000 built-in gain. The buyer would take a $100,000 basis in the land. If the buyer purchased the stock of A and B, a rational buyer would only pay $72,800, which is the fair market value of the land less built-in gains taxes. Although the buyer would have a $100,000 basis in the C corporation stock, if the C corporation sold the land, it would still have to pay $27,200 of tax on $80,000 of built-in gain. A rational buyer would reduce the purchase price of the stock by the built-in gains tax to reflect the economic reality that the land is owned by a C corporation.

As rational sellers, A and B would accept $72,800 as payment for their stock. If A and B sold their stock to the buyer for $72,800, together they would net $62,240 after payment of personal income taxes. (See table 1 on page 7.) This is the same amount A and B would net after taxes if the C corporation was liquidated, the land was distributed to them, and they sold it to a buyer for $100,000. (See table 2.) As rational sellers, A and B should recognize that $72,800 is a fairly negotiated price for their stock in the C corporation. The example demonstrates why it is appropriate to take into account the full built-in gains taxes in determining the value of stock of a holding company organized as a C corporation.

An argument can be made that as long as the buyer doesn't liquidate corporate stock for a long time period after purchase, the present value of the built-in gain taxes will be minimal. Therefore, a minimal reduction in the price of holding company stock is warranted. However, this argument fails to consider two factors. The first factor is that the shareholder of a minority stock interest in a holding company has no control over the timing of a corporate liquidation. The second factor is that the land will continue to appreciate within the corporation after purchase of the stock. Both pre-purchase and post-purchase appreciation will be subject to a corporate level income tax upon ultimate corporate liquidation.

Note: In the next issue of *CPA Expert,* Leonard J. Sliwoski, CPA/ABV, and Mary B. Bader, CPA, JD, continue their discussion of business valuation considerations related to built-in gains taxes, focusing on holding companies organized as S corporations.

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EXPERT *Tools*

NOT JUST ANOTHER WEB DIRECTORY

A Review of Best Websites for Financial Professionals, Business Appraisers, and Accountants *by Eva M. Lang, CPA, ASA, and Jan Davis Tudor, John Wiley & Sons, Inc., $39.95, 226 pages, ISBN: 0471371572*

One of the hazards of the information age is we're inundated with website recommendations. It seems every business journal and newspaper lists four or five sites at least, briefly describing their content and perhaps assessing their value. In addition, articles we read in these resources (including this one) cite websites related to the subject of the article. One problem is the sources of these references give little and sometimes no information about a website's quality.

Gratitude, therefore, is the appropriate feeling for a book like *Best Websites for Financial Professionals, Business Appraisers, and Accountants* by Eva M. Lang, CPA, ASA, and Jan Davis Tudor. The book provides in one place a source of first-rate websites for CPA experts and other professionals, identifies their strengths and weaknesses, and offers general guidance to help practitioners use their time better when doing research on the Internet.

Eva Lang is Chief Operating Officer of the Financial Consulting Group, a contributing editor to *CPA Expert,* and a former member of the AICPA Business Valuation Subcommittee, still serving on the subcommittee's task forces. Jan Tudor is president of JT Research, Portland, Oregon, and a columnist for *EContent* magazine and she has written for *CPA Expert.* These knowledgeable and experienced authors have put together an exceptional resource that's bound to help all CPAs identify the right site with access to the high quality information needed to make solid decisions and draw valid conclusions. They point CPA experts to the rich reserve of resources available to help them reach valuation conclusions and calculate personal and commercial damages.

THE ECONOMIC REALITY OF INTERNET RESEARCH

Their approach to using the Internet for research is realistic and balanced. They focus on Internet resources, so they do not cover commercial information providers, such as Lexis/Nexis, WestLaw, Dialog, and other services, or financial services, such as Bloomberg and Securities Data. They do advise, however, that many of these services, once too costly for small firms and requiring complex protocols too time-consuming for some financial professionals to use directly, now have changed their pricing to target smaller firms, have made searching easier, and package content with the user in mind. "We strongly urge you," say the authors, "to consider subscribing to one of these services if you find that your information needs are increasing and can no longer be met by free and low-cost websites." They remind us that not everything ever published is on the Web, and what's on it isn't always free.

SAVING TIME AND MONEY

Moving on to using the Web, the authors provide guidance to many users who find Internet searching to be frustrating: Either too few sites are identified, or so many that they spend valuable time identifying the sites that seem to be appropriate and then accessing them to find out if they in fact are. In the first chapter of *Best Websites,* which focuses on "Searching the Internet," Eva Lang discusses using search engines to structure your search so that you same time and money. She explains the principles of Boolean logic and other advanced search features such as field searching and truncation. She also touches on the "Invisible Web," a source of valuable information hidden from search engines. (See her "Sighting Materials on the Invisible Web" in the Winter 2000 issue of *CPA Expert.*)

Then come the Websites. Each chapter in the book has a similar structure: introductory discussion followed by a list of websites. The websites are classified in two categories:

- *First and Foremost,* which contains sites "the authors have found to be reliable, well organized, and rich sources of information. Sites offering all or part of the data for free are considered more desirable than sites offering similar data for a fee."
- *Best of the Rest,* which are sites that "may focus on a niche area, be fee only, or have limited navigation or output features."

Each site listed is identified as free, fee-based, or both.

The list at the end of Chapter 1 contains specialty and general search tools with a brief discussion of each site's features as well as caveats for users. Chapter 1 alone, if readers follow its guidance and tips about the sites, should justify the price of the book for any financial professionals whether or not they provide business valuation or litigation services.

Each of the following nine chapters of *Best Websites* focuses on particular subjects: economic research; industry research; public company analysis; private company analysis; salary, executive compensation, and surveys; mergers and acquisitions; intellectual property; tax and accounting; and international business. In the introduction to each area, the authors may give tips on how to plan a search in the area and ideas on finding other websites for their particular search that aren't included among the first and foremost or best of the rest because the information is specific to the search. In Chapter 2, "Economic Research," for example, Eva Lang advises readers to consider searching articles in local newspapers and business journals and checking with local chambers of commerce when they are looking for information on local or regional economic conditions.

Facing the pressures of time, readers may be tempted to skip the introduction and go directly to the lists of websites. Doing so will serve them well. However, they're likely to miss some useful guidance such as the discussion of how to develop an effective plan of approach to researching industry information that is in Chapter 3, "Industry Research."

The authors caution readers that some of the websites may be defunct by the time they try to access them. Such is the case of Pro2Net, which closed while *Best Websites* was being printed. Given the high quality of the websites listed in the book, however, it seems likely that 99.4% percent of the sites listed will be going concerns for a long time.

In developing this book, Eva Lang and Jan Tudor have done a great service for providers of business valuations and litigation services and other financial and accounting professionals.

EXPERT *Opinion*

THREE WRONGS MADE RIGHT

Robert A. Mathers, CPA/ABV, JD

On May 14, 2001, the Ninth Circuit Court decided two cases dealing with the fair market value of two separate closely held businesses in *Estate of Simplot* v. *Commissioner* (No. 00-70013; 9th Cir. 5/14/01) and *Estate of Mitchell* v. *Commissioner* (No. 99-70421; 9th Cir. 5/14/01). After chastising the Tax Court for erring by disregarding critical evidence, the Ninth Circuit stressed that the lower court's interpretation of minority shareholder motivations is not on point in determining value. Following its March decision instructing the Tax Court not to reject market comparable evidence without good reason, the Ninth Circuit also declared once again that splitting the experts' opinions in half equated to incomplete conclusions of law.

THE CIRCUIT COURT'S SKEPTICISM

In the *Simplot* case, Richard Simplot owned minority interests in both voting and nonvoting stock in his family owned business. The Tax Court valued the voting stock at $801,944 per share, versus $3,585 per share for the nonvoting stock, finding the voting shares to have the potential for more influence and control than the nonvoting shares. The estate valued both classes of stock at $2,650 per share.

The Ninth Circuit found the Tax Court's speculation about the potential influence and control of the voting shares to be an incorrect finding. The higher court reprimanded the Tax Court for creating imaginary scenarios about who the prospective buyer might be.

REJECTING A SOLOMONIC DECISION

Not surprisingly, the Ninth Circuit dealt with a similar issue in *Estate of Mitchell* v. *Commissioner* when at issue was the value of Paul Mitchell's interest in his successful hair care products company. In this case, the Tax Court straddled the range of values created by the taxpayer's and government's experts, stating that its determination of value was within the range of testimony presented by the experts. The Ninth Circuit rejected this Solomon-like finding.

THE CIRCUIT COURT'S REBUKE

Earlier this year, in *Morrissey* v. *Commissioner* (No. 99-71013 (9th Cir. 3/15/01)), the Ninth Circuit rebuked the lower court when it ignored the market approach to valuation. Finding that there were in fact separate sales of stock close to the valuation date, which were arm's length transactions, the Tax Court ignored the evidence without good reason.

The conclusion we can arrive at in reading these cases, decided in early 2001, is that the Ninth Circuit will uphold the "willing buyer, willing seller" standard in defining "fair market value" in estate tax cases. Valuation experts and attorneys alike need to ensure that valuation conclusions are supported with facts, not speculation about perceived influence and control. Actual transactions speak louder than hypothetical estimates, and, as is stated in Revenue Ruling 59-60, should be accorded more weight. Finally, the expert needs to be able to educate the trial court. Often in Tax Court, the expert's testimony is significantly truncated; therefore, expert opinions and their reports need to stand on their own.

Robert A. Mathers, CPA/ABV, JD, is a partner with Clifton Gunderson LLP, Oshkosh, Wisconsin. He is a member of the AICPA Trust, Estate, and Gift Tax Technical Resource Panel.

AICPA STANDARDS RELEVANT TO LITIGATION SERVICES

D. Paul Regan, CPA, and Roger B. Shlonsky, CPA

The subject of standards and the responsibilities of CPAs providing litigation services, including expert witness testimony, continues to be considered and debated in different forums, including the AICPA Litigation and Dispute Resolution Subcommittee. While such consideration is ongoing, it is important for CPAs to understand that certain standards and references to their application—or relief from their application—does exist in AICPA pronouncements. In addition, AICPA practice aids and special reports, although not authoritative documents, discuss application of professional standards in providing litigation and related services.

References to litigation services in the AICPA professional standards appear in the following literature: Statements on Standards for Attestation Engagements; Statements on Standards for Accounting and Review Services; the Statement on Standards for Consulting Services; and the Code of Professional Conduct. The references appear as follows:

- Definition of the client (ET 92.01)
- Professional services (ET 92.10)
- Applicability of standards (ET 91.02)
- General standards with regard to professional competence, due professional care, planning and supervision, and sufficient relevant data (ET 201, ET 55, and ET 5605)
- Litigation engagements typically provided by practitioners that are not considered attest engagements (AT 100.02)
- When litigation services may include an attest engagement (AT 100.05)
- When litigation services that include financial forecasts and projections as part of the litigation support service are not applicable to professional standards (AT 200.03)
- Reference to professional standards as useful guidance in litigation services that include financial forecasts and projections (AT 200.03)
- Possible inapplicability of the exception of the professional standards as to financial forecast and projections when used as part of litigation support process (AT 200.03)
- Exclusion of reporting on an entity's' internal control as part of a consulting engagement (AT 400.01d)
- Agreed upon procedures engagements as a part of the litigation support service engagement (AT 600.02f and g)
- Exclusion from compilation and review standards (AR 9100.76–.79)
- When compilation and review standards apply to litigation services (AR 9100.78 and .79)
- Litigation services as a consulting services (CS 100.05–.06)

STANDARDS APPLICATIONS

Several nonauthoritative AICPA publications discuss litigation and related services, including specific standards that apply. The following list of these AICPA Consulting Services Practice Aids (CSPA) and Consulting Services Special Reports (CSSR) contains their titles and product order numbers:

- *Providing Litigation Services* (CSPA 93-4; no. 055145CX)
- *Application of AICPA Professional Standards in the Performance of Litigation Services* (CSSR 93-1; no. 048562CX)
- *Conflicts of Interest in Litigation Services Engagements* (CSSR 93-2; no. 048563CX)
- *Communicating Understandings in Litigation Services: Engagement Letters* (CSPA 95-2; no. 055163CX)

- *Communicating in Litigation Services: Reports* (CSPA 93-2; no. 055000CX)
- *Fraud Investigations in Litigation and Dispute Resolution Services* (CSPA 97-1; no. 055001CX)
- *Providing Bankruptcy and Reorganization Services* (CSPA 98-1; 0551652CX)
- *Calculation of Damages in Personal Injury, Wrongful Death and Employment Discrimination* (CSPA 98-2; no. 055293CX)
- *Alternative Dispute Resolution Services* (CSPA 99-1; no. 055294CX)
- *Valuing Intellectual Property and Calculating Infringement Damages* (CSPA 99-2; no. 055295CX)
- *Comparing Attest and Consulting Services: A Guide for the Practitioner* (CSSR 93-3CX)

In addition the AICPA has recently published *A CPA's Guide to Valuing a Closely Held Business* (no. 056601CX) by Gary R. Trugman, CPA/ABV, which is a significant revision of the earlier CSPA 93-3, *Conducting a Valuation of a Closely Held Business.*

The various references to applicable standards and sources of reference to them are neither applicable in all instances nor all-inclusive. As a practical matter, any time a CPA provides any specific form of service covered by any of the various standards as a part of his or her analysis, conclusions, or opinions, it is possible that standards otherwise inapplicable may apply. For example, an opinion with regard to a particular application of an accounting standard and the work that the CPA performed with regard to the application to that standard may bring into play standards otherwise not applicable to the CPA's performance.

STATEMENT OF RESPONSIBILITIES

The AICPA continues to consider these issues. To help clarify the issues for practitioners, the AICPA Litigation and Dispute Resolution Services Subcommittee is developing a summary identifying the standards and their applications through a statement of responsibilities. The subcommittee expects a public exposure draft to be ready in the first quarter of 2002. AICPA members and other interested parties will then have an opportunity to react to the exposure draft before a final document is published.

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